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Is the U.S. Current Account Deficit Sustainable?

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The U.S. current account deficit, driven by the United States' widening trade deficit, is the largest it has ever been, both as a share of the U.S. economy and in dollar terms. How much longer can the United States continue to spend more than it earns and support the resumption of global growth?

The United States is enjoying an economic boom that is fueling the growth of its trade deficit. At current exchange rates, the strength of the U.S. economy, combined with slow growth in demand in many other parts of the world, will lead to further widening of the U.S. trade deficit. How long can the trade deficit continue on that trajectory without disrupting the U.S. economy or the world economy?

Absent structural reforms in the United States and abroad, a large devaluation of the dollar, or significant changes in the business cycle, both the trade and the current account deficits will continue to widen until they become unsustainable, perhaps two or three years out. Changing the trajectory will be difficult. The U.S. trade deficit is now so large that even if world economic growth were to pick up and boost U.S. exports, U.S. imports would have to slow dramatically for the gap to narrow. To shrink the trade deficit significantly, say, over a two-year period, exports would have to grow twice as fast as they did in the 1990s, when growth averaged 7.5 percent a year, and the growth rate of imports would have to be halved, from 11 percent to 51/2 percent a year. Moreover, following twenty years as a net recipient of capital inflows, the United States will soon be confronted with much larger service payments.

At some point, either the United States' negative net international investment position and the associated servicing costs will become too great a burden on the U.S. economy or, more likely, global investors will decide that U.S. assets account for a big enough share of their portfolios and so will stop acquiring more of them. At that point, asset prices, including interest rates and the exchange value of the dollar, will adjust, reflecting the change of sentiment in the markets. A change in the value of the dollar alone would narrow the trade gap for a while, but the deficit would soon begin to widen again. To put the U.S. current account and trade deficits back on a sustainable path will require structural reforms in the United States and its trading partners that encourage faster global growth, boost U.S. household saving rates, better prepare U.S. workers for technological changes in the global economy, and open up markets for U.S. exports, particularly of services.

The deficit is not now a problem

The underlying trend widening of the U.S. trade deficit in 1999 was exacerbated by the financial crisis in Asia and its spillover effects on Latin America and Europe. The dollar appreciated as capital seeking a safe haven flowed into the United States, while the U.S. Federal Reserve System lowered interest rates in response to global and local financial distress. The growth of U.S. GDP accelerated, fueling an increase in imports. At the same time, U.S. export growth collapsed—the result of the worldwide economic slowdown and the strong dollar.

The trade deficit has some positive features. One of the factors driving the U.S. economic expansion has been productivity growth, itself driven by rising investment rates, sound investment decisions, and globalization. As much as half of the recent increase in productivity growth may be due to globalization—which comes from growth in foreign markets, increased competition in domestic markets from foreign suppliers, and the breaking up of the value-chain of production and its relocation to facilities in other countries. Higher productivity growth increases the likelihood that foreign investors' expectations of high rewards from their investments will be realized.

Consequently, rapid productivity growth has made the United States extremely attractive to both domestic and international investors, reflected in a growing appetite for U.S. assets. In 1998, 45 percent of international debt securities outstanding, and 57 percent of new security issues, were in dollars. U.S. government bonds accounted for about 30 percent of the entire global bond market—commercial and sovereign. If about 50 percent of the projected increase in the value of the global portfolio is invested in U.S. assets, the United States will, roughly, maintain its share of world asset markets.

The size and composition of foreign capital inflows enable the U.S. deficit to widen further. The United States' net external financial obligations, in terms of both the total stock outstanding (about $1.5 trillion) and net service payments ($25 billion), are small in relation to its $9 trillion economy. The United States borrows almost exclusively in domestic currency; more than 90 percent of its external debt to banks is in dollars. In addition, most of the private capital flowing into the United States consists of foreign direct investment and portfolio investment. If foreign investors sold off their holdings of U.S. equities and bonds, the prices of their assets would likely decline; they are therefore more motivated (compared with, say, bank lenders) to hold on to them. Finally, a large share of international transactions are denominated and carried out in dollars, which keeps demand for dollars high and demand for highly liquid U.S. government securities strong. All told, the United States can afford to carry a larger external deficit than a country whose obligations consist primarily of contractually fixed, short-term bank loans denominated in foreign currencies.

Sustainability requires structural changes

Nonetheless, the United States cannot live beyond its long-term means forever, nor will U.S. assets always be so favored by global investors. At current exchange rates and assuming a resumption of sustained growth in the world economy, by 2005 the current account deficit will be about $600 billion—more than 5 percent of GDP. This is both a large volume of assets, in dollar terms, that the United States is offering to international investors, as well as an unprecedented (for the United States) share of GDP. To avoid a sustainability episode in the future, it is critical that structural reforms start now. Never has the economic climate in the United States been so propitious for tackling these reforms—including raising U.S. household saving rates and preparing U.S. workers for change—and never have reforms been so necessary abroad—including liberalizing markets and lowering trade barriers, particularly in the service and professional sectors.

Fiscal discipline has been key to the U.S. economic expansion, but fiscal irresponsibility was replaced by excessive household spending. When households spend more than they earn, it is difficult for government savings to make up the shortfall in savings because the import intensity of government output is about one-third the import intensity of consumer spending. So higher household consumption has a disproportionate effect on the trade deficit. Although the drop in measured household savings was particularly dramatic in 1999, a downward trend has been apparent for 15 years. Household spending in recent years has been driven by capital gains and unrealistic expectations that wealth will continue to increase at the same rate in the future as in the recent past. In the face of a downturn in the market, U.S. consumers would tend to borrow to maintain their current consumption patterns, making them vulnerable to higher interest rates and a prolonged economic slowdown.

Moreover, worker preparedness for the types of jobs that are emerging in the "new economy" is inadequate. A trade deficit can be good news—the trade deficit tends to widen when the U.S. economy is strong. But trade growth and technological change, which go hand in hand, can mean a difficult adjustment for workers in sectors that are contracting. However, trade growth and technological change will foster the development and expansion of other sectors, and the more flexible workers and firms are in their ability to adapt and to join the expanding sectors, the less likely is a backlash against globalization.

There is a limit to the role that investment capital can play in raising productivity; over the longer term, labor force preparation and performance are critical. The United States cannot keep its competitive edge, maintain rapid productivity growth, and raise living standards unless its workers are world class. High-technology services and goods have grown as shares of U.S. production, imports, and investments. Between 1996 and 1998, real net investment in computers and peripherals rose more than 40 percent a year; they now account for nearly half of the nominal nonresidential capital stock. High-tech capital requires highly skilled workers. Moreover, because skilled workers earn higher wages and are more likely to be employed, preparing workers for the jobs of the future might lessen the political tensions aroused by globalization and encourage higher household saving rates.

Studies by the McKinsey Global Institute of selected service sector industries suggest that labor productivity in the United States is greater than in France, Germany, Japan, and the United Kingdom by 30 percent in the airline industry, 30 to 40 percent in retail banking, 20 to 50 percent in telecommunications, and 10 to 50 percent in retail selling. In part because the U.S. domestic market for services is so well developed, the United States is the world's leading exporter of business and professional services. The service sector overall contributed a positive $76 billion to net trade in 1999, whereas goods trade was in deficit by about $345 billion.

The share of services in U.S. exports should increase further as the United States' trading partners grow and mature. For example, services account for about 35 percent of U.S. exports to the mature economies of Europe, where the share of services in GDP is about 70 percent; 25 percent of U.S. exports to South and Central America, where the service share of GDP is about 57 percent; but only 18 percent of U.S. exports to China and India, where the service share of GDP is 37 percent. Multilateral liberalization of services would help put the U.S. trade deficit on a sustainable path. As other countries open their markets to U.S. exports of services, contributing positively to the overall U.S. trade balance, U.S. imports of some services would also increase. Even more important, liberalization of services in markets abroad would spur much faster economic growth there—enough to raise global growth rates from 3.2 percent to 5 percent a year in the long run, according to the Organization for Economic Cooperation and Development.

A global policy challenge

The widening U.S. trade deficit is a reflection not only of policy problems in the United States but also of economic doldrums abroad, which pose an immediate challenge to policymakers there. Just as the U.S. trade deficit has both cyclical and structural aspects, so have the foreign economic doldrums. Japan's lost decade, tepid growth in many European economies, questions about the sustainability of Asia's rebound from the 1997 crisis, and Latin America's economic volatility—all make it difficult for the U.S. trade deficit to change direction based on U.S. actions alone.

A global expansion would benefit the U.S. economy; obviously, it would also be good for other countries. There, as in the United States, the key to raising long-term sustainable growth is faster productivity growth, which will come with increased market flexibility and globalization. This recipe would raise U.S. and global growth rates and put the U.S. trade and current account deficits on a sustainable trajectory. It is a win-win scenario.

Moreover, if structural reforms accompanied rising domestic demand in countries whose economies were growing, these countries would be able to offer higher returns to domestic and foreign investors. Investors would increase the share of non-U.S. assets in their portfolios, and the dollar would drift lower. Faster growth abroad and a modest drop in the dollar would stimulate the growth of U.S. exports and slow the growth of imports, and the U.S. current account gap would shrink. If such a shift occurred smoothly, the U.S. economy could continue to expand for quite some time, amid robust and sustainable global growth.

If other economies continue to stagnate and needed structural reforms are postponed, however, U.S. investments will continue to yield higher returns than those in other countries; foreign investors will continue to acquire U.S. and dollar-denominated assets; and the current account deficit will grow wider. When a change in investor sentiment comes, it could be dramatic. What would happen if the dollar depreciated by a significant amount, say 25 percent?

Although such a depreciation would quickly close the current account deficit, U.S. consumers would shift from buying imported goods and services to buying those made domestically, and U.S. labor markets would tighten further. The combination of rising wages and a falling dollar likely would drive up prices. The U.S. Federal Reserve would probably raise interest rates, putting the brakes on the U.S. economy. A rapid change in the dollar's value and a raising of interest rates would likely disrupt financial markets, with knock-on effects on consumption and business investment in the United States and throughout the world.

Even though a sudden depreciation would be costly, it still would not put the current account on a sustainable trajectory. Absent structural changes in the U.S. and other economies, a sudden, significant depreciation would set off a dangerous cycle: the trade and current account deficits initially would narrow but they would soon widen again, as structural instabilities returned to the fore. Moreover, because a depreciation would affect only the trade component of the current account, its impact would wear off more quickly than did the impact of the depreciation of the dollar in the 1980s.

The United States' external deficits have widened dramatically during a period in which the U.S. economy has been robust, while stagnation and financial crisis have swept through much of the rest of the world. But, because globalization has enhanced productivity growth and because the United States is a central participant in international markets, the external situation is not yet unsustainable. Strong domestic demand in the United States can continue to support the transition to demand-led growth abroad for two or three more years. However, structural asymmetries in the components of the U.S. internal and external balances, as well as political and market sensitivities toward growing trade deficits, will unleash economic forces that ultimately could undermine the sustainability of the U.S. deficit. A failure to address policy and structural needs, in the United States and abroad, increases the likelihood that the resolution of the U.S. trade imbalance will be unpleasant and disruptive for the world economy.

This article is based on the author's book, Is the U.S. Trade Deficit Sustainable? *(Washington: Institute for International Economics, 1999).*

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